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Section 121 Exclusion and Like-Kind Exchange on Same Property?

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Section 121 Exclusion and Like-Kind Exchange on Same Property?

-by Neil E. Harl*

It has been possible to claim the I.R.C. § 121 exclusion (\$250,000 on a separate return, \$500,000 on a joint return)¹ in conjunction with the involuntary conversion provision². But authority has been lacking for using an I.R.C. § 121 exclusion along with like-kind exchange treatment.³ In late January, 2005, the Internal Revenue Service published guidance for doing precisely that – coupling the Section 121 exclusion with like-kind exchange procedures.⁴ The guidance is effective January 27, 2005 but taxpayers may apply the rules in taxable years for which the period of limitation has not expired.⁵

Requirements for the § 121 exclusion

The new procedure specifies that the rules already in place for the two provisions must be met. There is no change in the statutory framework for either the exclusion or the like-kind exchange requirements.

For the exclusion under I.R.C. § 121, it is necessary for a taxpayer to have owned the residence and occupied it as the principal residence for at least two of the last five years prior to the sale or exchange.⁶ It is important to note that an owner's period of ownership of a residence includes the period during which the taxpayer's deceased spouse owned the residence.⁷ For transfers of residences incident to a divorce, the time the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's own period of ownership.⁸ Moreover, a taxpayer owning a residence is considered to have used it as a principal residence while the spouse or former spouse is given use of the residence under the terms of the separation or divorce.⁹

However, one way or another, the taxpayer must establish ownership and occupancy for two or more of the last five years before the sale or exchange.

Requirements for like-kind exchanges

The basic requirement for a like-kind exchange is that the property involved must be held for productive use in a trade or business or for investment and must be exchanged for like-kind property which is to be held for productive use in a trade or business or for investment.¹⁰ Although there have been numerous rulings and cases on what is like-kind,¹¹ real property qualifies as like-kind to other real property regardless of dissimilarities.¹²

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Note that the like-kind exchange requirements must be met at the time of the exchange.¹³ There is no requirement for the property to have been held for productive use in a trade or business or for investment for a specified period prior to the exchange.¹⁴

Example

The newly issued authority, *Rev. Proc. 2005-14*,¹⁵ begins the analysis with the observation that neither I.R.C. § 121 nor I.R.C. § 1031 addresses the application of both provisions to a single exchange of property.¹⁶ The newly issued authority notes, however, that Congress has provided rules for applying I.R.C. § 121 with another nonrecognition provision, I.R.C. § 1033.¹⁷ Under the involuntary conversion rules of I.R.C. § 1033, IRS points out that gain is recognized only to the extent the amount realized from the compulsory or involuntary conversion of property exceeds the cost of qualifying replacement property.¹⁸ The basis of the replacement property is its cost reduced by the amount of gain not recognized.¹⁹ That is the basic approach followed for Section 121 exclusions and like-kind exchanges in the new ruling.

To illustrate the application of the exclusion and like-kind rules, assume an unmarried individual, A, purchased a farm in 1990 and built a new home costing \$210,000. A used the residence as the principal residence from construction of the house in 1991 through the end of 2002. During 2003 and 2004, A rented the farm and the house to tenants and claimed depreciation deductions totally \$20,000 on the house. In late 2004, A exchanges the farm and the house for a townhouse complex in town. A separated the transaction into the house and the rest of the farm. The house portion was exchanged for \$10,000 in cash and a townhouse with a fair market value of \$460,000. A intends to rent the entire complex to tenants including the townhouse received in exchange for the farmhouse. A realizes gain of \$280,000 on the exchange (the original basis of \$210,000 minus depreciation of \$20,000 equals \$190,000; the \$460,000 value of the property received plus the \$10,000 of boot minus \$190,000 equals \$280,000).

A's exchange of the principal residence that A has rented for two years satisfies the I.R.C. § 121 requirement that the residence have been owned and occupied as the principal residence for at least two of the last five years before sale.²⁰ The exchange of a farm and house which had been rented to tenants for two years for a townhouse complex which A intends to rent to tenants indefinitely satisfies the requirements of I.R.C. § 1031.²¹

A can exclude \$250,000 of the \$280,000 of realized gain under I.R.C. § 121.²² A can defer the remaining realized gain of \$30,000 (including the \$20,000 gain attributable to depreciation) under I.R.C. § 1031.²³

What about the \$10,000 boot? A is not required to recognize the boot as gain because boot is taken into account under like-kind exchange rules only to the extent the boot exceeds the

amount of excluded gain with respect to the relinquished business property.²⁴

So what is A's basis in the townhouse as replacement property for the farmhouse? A's basis in the townhouse is \$430,000, which is equal to the basis of the relinquished property (\$190,000) increased by the gain excluded of \$250,000 and reduced by the cash A receives (\$10,000).

In conclusion

In many instances, particularly involving farm residences, the amount of the allowable exclusion will more than cover the gain involved. But in other situations, the new procedure may allow deferral of realized gain into replacement property.

FOOTNOTES

¹ I.R.C. § 121(b)(1), (2). See generally Harl, *Agricultural Law* § 48.02 (2004); Harl, *Agricultural Law Manual* § 6.03[2] (2004). See also Harl, "More Detail on the Principal Residence Exclusion," 14 *Agric. L. Dig.* 9 (2003); Harl, "Excluding Gain on Sale of Residence," 14 *Agric. L. Dig.* 105 (2003).

² I.R.C. § 1033.

³ I.R.C. § 1031.

⁴ *Rev. Proc. 2005-14*, I.R.B. 2005-7.

⁵ *Rev. Proc. 2005-14*, § 6, I.R.B. 2005-7.

⁶ I.R.C. § 121(a).

⁷ I.R.C. § 121(d)(2).

⁸ I.R.C. 121(d)(3)(A).

⁹ I.R.C. § 12(d)(3)(B).

¹⁰ I.R.C. § 1031(a)(1).

¹¹ See Harl, *supra* note 1, § 27.04[3].

¹² *Id.*

¹³ I.R.C. § 1031(a)(1).

¹⁴ *Id.*

¹⁵ I.R.B. 2005-7.

¹⁶ *Rev. Proc. 2005-14*, § 2.07, I.R.B. 2005-7.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ I.R.C. § 121(a).

²¹ I.R.C. § 1031(a)(1).

²² See *Rev. Proc. 2005-14*, § 4.02(1), I.R.B. 2005-7.

²³ *Rev. Proc. 2005-14*, § 4.02(2), I.R.B. 2005-7.

²⁴ *Rev. Proc. 2005-14*, § 4.02(3), I.R.B. 2005-7.